II.B.5 Safety Net Reform

Over the past several years, many donors have begun devoting increasing resources towards strengthening and reforming "safety nets" - broadly defined here as the set of programs and legal/regulatory measures designed to protect the public at large, particularly those of modest means, from falling into poverty. In the financial sector, this has centered on pension systems, insurance and financial assurance mechanisms, such as deposit protection and investor protection.

Pension Reform

The pensions system is a financial sub-sector that had previously been sometimes overlooked by international donors, though the performance of a country's pension system can have far-reaching impacts on many aspects of society and many sectors of the macroeconomy. Successful pension systems provide basic incomes to retired workers and help mobilize savings for investment in the capital markets, an aspect that is particularly important in developing countries. All pension systems strive to achieve four basic objectives:

- To provide adequate old age income to those individuals participating in the system;
- To provide coverage to as many workers as feasible, focusing resources on those workers most in need of old age income support;
- To ensure the long-term financial sustainability of the pension program; and
- To support, or at least not hinder, economic growth through appropriate financing mechanisms

Many pension programs in countries across different regions and levels of development, are now confronting similar issues. A combination of demographic trends, economic conditions and poor plan design has rendered many pension systems financially unsustainable. In response to these problems, many countries are adopting a "multi-pillar" system with a mandatory, government administered, pay-as-you-go first pillar, a second pillar that is a fully funded, defined contribution system with individual accounts often managed by private fund managers, and a voluntary third pillar based on retirement savings plans sponsored either by employers or individuals. The individual pillars are tailored to meet each country's unique issues and constraints.

Most donors are well placed to provide technical assistance for pension reform. Providing assistance for pension reform is in line with strategic objectives of fostering private sector growth, reducing poverty, and building institutional capacity. Some trends in reform are as follows:

- **Overall Pension Policy and Reform:** There is considerable work on a policy level to develop an appropriate, long-term pension strategy and set the direction and framework for its implementation. It also includes support for pension modeling with parametric variations (i.e. increasing retirement age, strengthening link between contributions and benefits, indexation, etc.). Work is also being done to determine whether to introduce new programs and to design corresponding structures and management of the transition phase.

- **Regulation and Supervision:** Without proper regulatory and supervisory systems, funds are susceptible to misappropriation or improper investment. Assistance efforts help to define the set-up, organization and functions (licensing of fund management companies, monitoring and inspection systems, problem resolution and punitive sanctions) of a pension supervisory agency and to develop pension regulations (licensing criteria for pension fund management companies, advertising/marketing guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements).

- **Information Technology and Management Systems:** Data collection is critical for policymakers, the pension supervisory agency, pension funds and individual pensioners. IT/MIS systems must be able to capture data to perform both administrative and monitoring/surveillance tasks. Reforms involve upgrading records management systems, improving accuracy and timeliness of data collection systems, designing and implementing IT systems.

- **Corporate Governance:** The governance of pension funds is critically important, since the quality and performance of fund management can determine the income flows to which retirees are entitled, as well as the level of government funding of any shortfall between what the plans may promise (if they are defined benefit) and what they are capable of delivering. There is evidence of poor performance by many publicly managed pension systems is highly correlated with the extent of government-imposed restrictions on investments and the absence of pension board authority to govern investment decisions. There is growing awareness that public pension programs must be given a clear mandate-to maximize the returns for retirees-and not be assigned collateral social objectives; that the boards be insulated, to the maximum extent possible, from political influence; that the members of the board meet rigorous qualifications for serving and that they understand and avoid any conflicts of interest when administering these plans; and that the performance of the plans be disclosed regularly so that boards can be held accountable to their stakeholders.

- **Financial Management and International Accounting Standards (IAS):** Proper financial accounting is important to determine fund performance, track individual accounts, and monitor compliance. There is broad potential to help pension administration agencies to upgrade their financial management capabilities. This can be undertaken in conjunction with broad accounting reform programs and/or corporate governance programs.

- **Public Education and Advocacy:** Public education and advocacy programs are needed to educate the general public about the need and benefits of pension reform and to help existing pensioners determine whether or not to switch to newly established pension programs. Assistance efforts include surveys to determine what issues need to be addressed, followed by the design of a corresponding, comprehensive public education campaign. In addition, tools are being developed to help existing pensioners analyze the costs and benefits of switching to new systems.

- **Skill Development and Training:** In order for a pension system to be sustainable, those charged with implementing it must understand its complexities and have the capacity to oversee and refine the system. Activities include specific training programs in areas such as: (1) basic principles of pension reform including policy and financing, (2) actuarial analysis, (2) pension fund regulation and supervision, (3) pension fund management and (4) pension fund administration.

While pension systems form an integral and often very large part of many countries' financial systems, they are distinct from other subsectors, such as banking and securities trading, in two important respects. First, the primary objective of a publicly-funded or guaranteed pension program is to promote the well-being of its participants, and not to generate growth in national capital markets or provide a source of financing for government projects. This distinction becomes important in real-world decisions often faced by donors, such as whether to advocate for the allowance of foreign investment by a pension fund. Second, pension programs are often mandatory, whereas participation in the stock market or in the banking system is - at least nominally - voluntary. This carries an important implication for governments, and by extension, donors, in that it implies a government guarantee of fund performance, even if no explicit guarantee exists.

Depositor Protection Reform

As witnessed during the 1997-1998 Asian crisis, external shocks and even rumours can stimulate an unwarranted and immediate drop in confidence in a bank, or of group of banks (for example, all banks which are owned by or associated with a particular country or region), causing a run on deposits and present the risk of failure of one or more banks. Explicit deposit protection schemes are increasingly being introduced as a mechanism to boost depositor confidence and add a further layer of comfort to reduce the risk of withdrawal and the flight of funds from one bank to another, or one jurisdiction to another.

There is a growing trend in favor of explicit forms of deposit protection. For example, deposit protection arrangements have been harmonized throughout the countries of the European Union. More recently, the G22 Working Party on Strengthening Financial Systems has recommended that each country should put in place explicit deposit protection arrangements, with a clear specification of the nature of protection provided and the means of defraying the costs. The IMF has endorsed a limited form of deposit protection in its code of best practices. In addition, the Financial Stability Forum ("FSF"), a forum formed by the G7 countries to promote international financial stability, has created a Working Group to develop international guidance on deposit insurance in recognition of the crucial role of deposit insurance in contributing to confidence in the financial system.

- **Move towards limited explicit protection:** Many countries currently offer explicit comprehensive guarantees to all bank depositors and other creditors. However, there is a trend to create systems of explicit limited protection[22]. Policymakers are increasingly becoming aware that a well-designed system of explicit limited protection can limit the government's financial commitment by requiring banks to contribute toward the compensation that is to be paid, contain moral hazard, offer prompt protection to the small depositor and reduce his/her propensity to run[23].
- **Need for best practice design:** Sixty-seven countries currently have systems of explicit limited protection. Unfortunately, most of them depart from good practice in a number of respects. The deposit insurance schemes in place in Japan and Korea proved unable to protect the financial system from the Asian crisis, and the authorities granted blanket coverage temporarily. Mexico followed a similar path. The operative phrase here is "well-designed." Recent efforts to develop better deposit protection design have

[22] *Finland and Sweden offered explicit full guarantees during their crises, but have now removed them and replaced them with limited coverage. Honduras, Indonesia, Japan, Jamaica, Korea, Mexico, and Thailand plan to replace their blanket guarantees in due course. Kuwait currently has an implicit full guarantee, but is considering switching to limited coverage. Costa Rica offers full guarantee by law to depositors and creditors of its state-owned banks, but is planning replacing it with an explicit limited system for both publicly and privately-owned banks.*

[23] *The World Bank's (WB's) position on limited explicit protection seems more ambiguous. Operational departments have frequently been instrumental in initiating deposit protection schemes in a number of emerging-market countries. But recent research at the WB (Demirguc-Kunt and Detragiache, 1998 and 2000 and Honohan and Klingebiel, 2000) has stressed an historical association between the existence of a deposit protection scheme and the incidence of financial crisis. This correlation may be valid, but in fact, likely results from the poor design of the systems in operation in the countries that have experienced crises or indeed simply reflect that countries at risk tend to impose such schemes to lessen risk to the general public.*

centered on aspects such as: reducing moral hazard risks by limiting protections to small depositors, the introduction of risk-based premiums, making operations more transparent, public outreach to reduce expectations around implicit guarantees, increasing reliance on market discipline as an early warning of distress.

Investor Protection Reform

Efforts to strengthen protection of investors have centered primarily on three areas: 1) More stringent setting and enforcement of disclosure requirements of publicly traded securities; 2) tougher regulation of the market conduct, promises, and undertakings of financial intermediaries; and 3) statutory requirements for the creation of investor protection schemes. All of these areas are integral components of capital market development initiatives being implemented in various parts of the world.

II.B.6 New Financial Products

New financial product and market designs have been made possible by improved computer and telecommunications technology as well as advances in the theory of finance during the past quarter-century. Product innovations have led to dramatic changes in the structure of global financial markets and institutions, in particular a partial shift from intermediaries to markets in the provision of finance.

Markets are developing to meet the needs of a wider range of users. These developments include securitization and its application to a wider range of financing activities, the development of corporate debt markets and continuing growth of investment in market-linked instruments relative to deposits and similar instruments offered by intermediaries. In addition, markets are providing a means of managing risk through a wide range of derivative instruments. Key developments related to the emergence of new products and services are summarized below:

Derivatives - From Credit Risk Intermediation to Global Risk Intermediation: Nowhere has product innovation had a more profound impact on the evolution of financial markets than the development, refinement, and broad-based adoption of derivative securities such as futures, options, swaps and other contractual agreements. Those innovations in financial-contracting technology have improved efficiency by expanding opportunities for risk sharing, lowering transaction costs and reducing information and agency costs.

In providing the means for pricing and risk measurement of derivative securities, finance science has contributed fundamentally to the remarkable rate of globalization of the financial system. The flexibility created by the widespread use of derivatives as well as specialized institutional designs provided an effective offset to dysfunctional country-specific institutional rigidities. Furthermore, derivative-security technologies provide efficient means for creating cross-border interfaces among otherwise incompatible domestic systems, without imposing invasive, widespread changes within each system. For that reason, future development of derivative-security technology and markets within smaller and emerging-market countries may help form important gateways of access to world capital markets and global risk sharing.

The use of derivatives has been growing rapidly in recent years. The most recent statistics from the Bank for International Settlements indicated that the notional amount of over-the-counter derivatives outstanding totaled $111 trillion in December 2001, up from $80 trillion just three years earlier. For exchange-traded derivatives, notional amounts outstanding rose from $14 trillion to $24 trillion over the same period.

Increasing Reliance on Sophisticated Tools: Today no major financial institution in the world, including central banks, can function without the computer-based mathematical models of modern financial science. The specific models that these institutions depend on to conduct their global derivative pricing and risk-management activities are based on the option pricing methodology. Growing complexity of products and the need for more rapid decision-making will require increased reliance on computer models and with that, a need increased managerial attention to the reliability of those models along with a more seamless interface between computer-model generated recommendations and human judgment. All of this implies a growing need for higher skill among financial practitioners and regulators.

Disintermediation and Corporate Bond Market Development: Disintermediation is the process of borrowers bypassing balance sheet intermediaries and obtaining finance directly from the capital markets. The development of corporate bond markets and securitization in many countries indicates the competition faced by traditional intermediaries for the provision of credit. The increasing capacity of large firms to access capital markets for credit is both a by-product of technology and the increasing sophistication of markets in developed economies.

Securitization: Securitization[24] as a technique gained popularity in the US in the late 1970s and was substantially supported by legislation, favorable tax treatment, government-guarantee mechanisms, and a pragmatic regulatory environment. The market for securitization in the US has since diversified from

[24] *Securitization is a process through which illiquid assets are transferred into a more liquid form and distributed to a broad range of investors through the capital markets. The lending institution's assets are removed from its balance sheet and are instead funded by private investors through the sale of negotiable financial instruments with credit-worthiness, which is of higher quality than the underlying assets themselves or than that of the originator.*

mortgage loans into a wide range of securities, including credit card receivables, small business loans, and other types of cash flow-generating assets. On a very limited basis special purpose vehicles are even being employed by banks and finance companies as a vehicle to securitize non-standard credits such as corporate loans, including real estate-backed non-performing and under-performing loan portfolios. The UK is the second largest source of asset securitizations. Other countries in Europe have been relatively slow starters, although regulatory and legislative changes have helped fuel new activity in some markets. Japan is the largest user of asset securitization in Asia, and is positioned for strong growth in the future. Following an amendment of its laws last year, it now has no restrictions on the activity.

Several types of securitization have grown rapidly over the past decade. One of the fastest growing has been asset-backed commercial paper, which soared from only $16 billion outstanding at the end of 1989 to more than $700 billion as of the second quarter of this year. Commercial mortgage securitizations have also proliferated noticeably since the early 1990s. The dollar amount of outstanding securities backed by commercial and multifamily mortgages has risen from $36 billion at the end of 1989 to nearly $400 billion as of this past June. In addition, commercial banks and finance companies have moved business loans off their books through the development of collateralized debt obligations. Securitized business loans amounted to $125 billion in the second quarter of 2002, up from a relatively miniscule $2 billion in 1989.

Special Purpose Vehicles: The past several years have witnessed significant developments in the use of special purpose vehicles ("SPVs"). Initially used by western banks in relatively simple transactions, such as the securitisation of self-liquidating mortgage loans, the notion of the SPV is now applied all over the world to more complicated financing transactions and for a variety of asset management and commercial purposes. In the context of asset restructuring, there are two general areas in which SPVs have been widely employed: troubled debt securitisation transactions and government-run asset management companies.

Product Bundling: Increasingly, banks are realizing the importance of non-interest (fee) income. Particularly with regards to middle market and SME lending, credit relationships are not seen as ends in themselves, but rather as one component of a larger client relationship that can include fee-based products such as payroll services, cash management and even financial advisory.

These trends will affect USAID Missions around the world to varying degrees. The table below on the following pages provides examples of some interventions, among many, that USAID might consider in response to the challenges that its client countries may face as a result of the trends discussed above.